DOW THEORY LETTERS INC.

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THE MARKET: Ever since the bear market began in February, 1966, the American public has been fed a diet of pap regarding "more inflation" in our time. This fear of inflation has been a prime rationale behind the boiling, speculative enthusiasm of the 1967 rally. But things are not always what they seem.

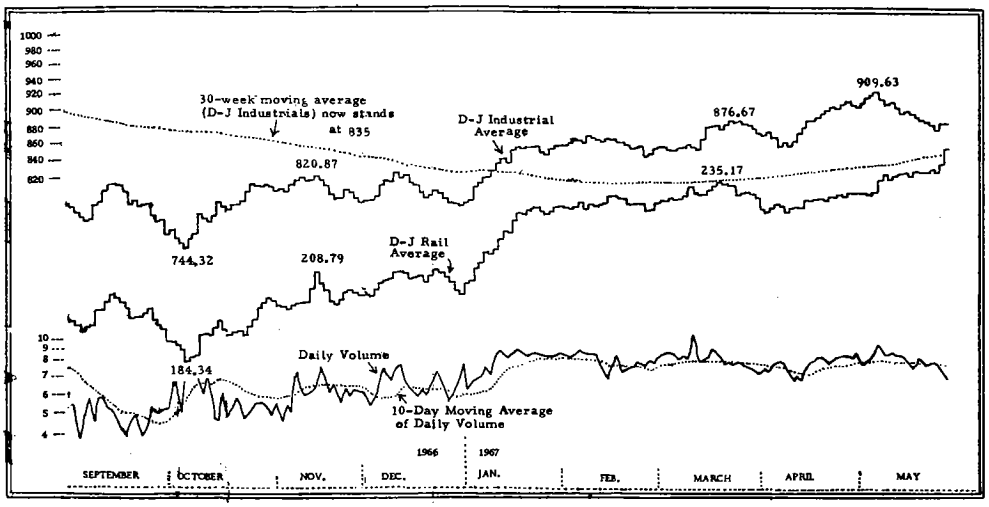
For instance, in the May 23 issue of Barron's, T.G. Campbell ("Bottom of the Till") states that there is a mass movement back to corporate liquidity. The fact is that U.S. corporations are now woefully short of cash. The new bond issues which dot every day of the calendar attest to this. When President Johnson attempted to fight a "big money" war while keeping the grandiose plans of the Great Society in high gear, he placed the nation in the position of wrecking its monetary structure.

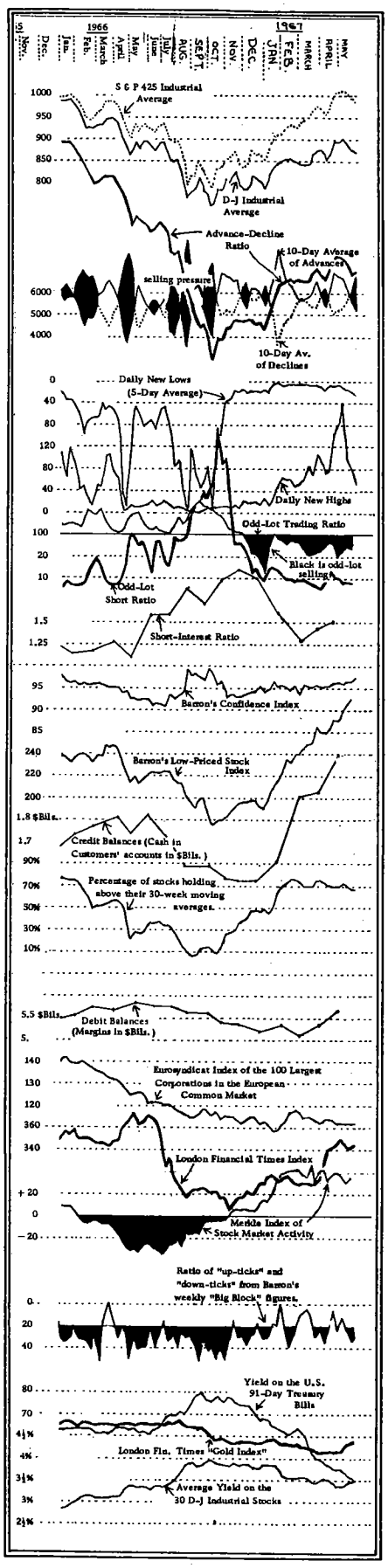
In his latest report, Alden Wells writes about "...the great mass movement towards liquidity now in progress. Since gold is the most liquid item in the world, the price of this precious metal is the ultimate beneficiary of any world move towards liquidity. Last year, for the first time in living memory, more gold was purchased by the public than was produced." With the halt in Treasury sales of silver, the price of that precious metal has moved sharply higher. Since the U.S. silver policy points the way to the future course of the U.S. gold policy, sales of gold on the London Exchange have soared. The ominous events in the mid-East have only intensified the world's appetite for the only commodity which through 5000 years of history has only moved only one way in price—up. That commodity is gold.

What does all this mean? In my opinion it means that the public has been chasing the wrong train; it means that the true danger facing Wall Street and the world is not inflation but deflation. Already world stock markets are deflating, world commodity prices have been deflating, the price of the dollar has been deflating, the price of bonds and high-grade stocks have been deflating. It remains only for the speculative enthusiasm of stock buyers to deflate, when this happens the world bear market (which started for the U.S. last year) will be on again in earnest. It is my belief that the forces of deflation will be out in the open for all to see before 1967 is out.

The stock market has not been unaware of coming events. Following the May Industrial peak of 909.63, a most ominous and extraordinary divergence built up between the two Averages, Industrials and Rails (while the Utility Average sagged steadily lower). Such divergence, following extended advances, almost always constitutes an important danger signal.

On May 23, unnoticed by almost anyone, the Industrial Average sank under the 50% level (869.73) of the entire 1966 decline. I consider this most significant. In March the

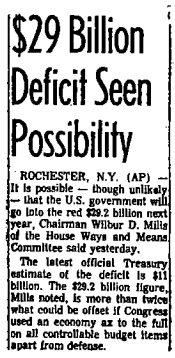



1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio
10-Day Average of Advances
selling pressure
10-Day Av. of Declines
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Media Index of Stock Market Activity
Ratio of "up-ticks" and "down-ticks" from Barron's weekly "Big Block" figures.
Yield on the U.S. 91-Day Treasury Bills
London Fin. Times "Gold Index"
Average Yield on the 30 D-J Industrial Stocks

 Industrials climbed above the 869.73 level, held above that level for 6 trading days, then broke sharply. A new rally began and for 24 trading days during April and May the Industrials held above the 869.73 level. The second attempt proved no more successful than the first, and by May 24 the Industrials had dropped below the halfway level again. Thus, the 30 D-J Industrial stocks, the stocks whose profits comprise better than 40% of all U.S. corporate profits, have been struggling to regain and hold half of the losses sustained during the 1966 bear market decline. On the two occasions when the Dow did climb above the halfway level, it was under conditions of speculative frenzy on the part of the glamour stocks and high flyers. But the fact is that the investment-grade issues have staged only a typical recovery during this bear market. It may be said that the blue-chips lagged the market on the rise and led the market on the way down. In other words, the rallying leadership was poor, the declining leadership was excellent.

It should be remembered that speculative froth does not end in a day. White hot speculation has been the impetus behind this recovery; it has been the "cover-up" behind which the high-grade stocks have been distributed. S & P's High-Grade Stock Index topped out in late-1965. The Dow topped in February 1966. My long-term volume studies peaked in late-March. I believe we are coming very close to the end of the speculative hysteria. When the froth is blown off, we will see the true meaning of the blue-chip deterioration. None of 1966's problems have been solved in 1967. Many of the problems are now worse, and new ones have entered the picture. The market is being held up by rising bubbles, but bubbles never last. After the party comes the sobering. The painful period is just ahead.

COMING MONEY FIASCO: Pity the poor bond buyers and sellers. With the bond markets sagging under a record amount of offerings, buyers are becoming increasingly reluctant to purchase new bonds and sellers are becoming increasingly anxious to float their issues and get their money before interest rates "go through the roof." Some sellers have been withdrawing their offerings in the hopes that the bond market will be better in a few months or so. Last week, for instance, New York City cancelled a $96 million issue and instead plans the sale of $28 million on June 6 if conditions warrant. Other cities, states and municipalities have been withdrawing offerings, while frustrated bond syndicates have been "breaking up" and dumping their unsold inventory for what the market will bring.



$29 Billion Deficit Seen Possibility

ROCHESTER, N.Y. (AP) — It is possible — though unlikely — that the U.S. government will go into the red $29.2 billion next year, Chairman Wilbur D. Mills of the House Ways and Means Committee said yesterday.

The latest official Treasury estimate of the deficit is $11 billion. The $29.2 billion figure, Mills noted, is more than twice what could be offset if Congress used an economy ax to the full on all controllable budget items apart from defense.

Meanwhile (see news clip) politicians and economists are vieing with each other in trying to estimate the size of the coming U.S. budget deficit. The softening corporate profit picture is calculated to cost the Government $4 billions in tax receipts, the restoration of the 7% investment credits will cost the Government an additional $1.5 billion, the chances of the proposed $5 billions tax boost are at best tenuous, and Congress has balked at the Government's $5.7 billions sale of "participation certificates." In the face of this Newsweek last week estimated that "....it isn't hard to reach a hair-raising deficit of at least $25 billions."

How will such a monster be financed? The Government could slap price and wage controls on the nation and then flood the country with more money. But foreign Central Banks are already casting palsied (if not frightened) looks at the dollar, and the gold market in London is boiling. Last week the price of gold went as high as $35.24, and gold shares spurted on the world's exchanges.

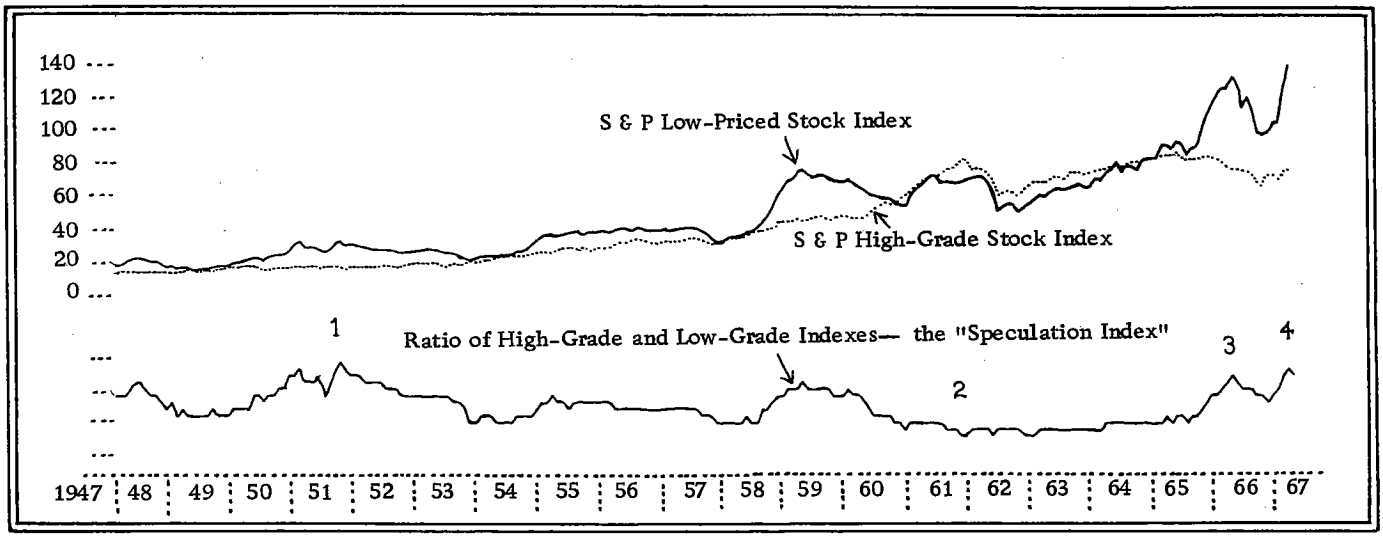
As long predicted here, the Communists are taking every advantage of the situation, for they could not care less whether they win their wars via bullets or economics (actually they would much prefer the latter). If debasement of a nation's currency is the way to its downfall (as Lenin claimed), then the Communists are more than willing to help us down that primrose path.

In Macao, in Hong Kong, in the Mid-East, the pressure is on. Russia's and China's answer to our escalation of bombing in North Vietnam has been to set off a series of potential new Vietnams across the face of the globe. The implications of the latest confrontation on the Israeli border is clear enough— Russia will consider cooperating with the West if the U.S. eases up bombing in North Vietnam. The U.S., spread too thin already and committed to be policeman of the Free World, faces the multiple problems of trying to prevent a gold run, attempting to halt Communist takeovers in an increasing number of areas, while keeping a shaky economy from falling on its inflated face. Can the U.S. succeed? Given the policies and abilities of the present Administration and its advisors, I must admit that I am rather dubious.

But my opinion is only an opinion. The stock market represents the calculations, insights, inside information and intelligence of some 20 million investors. Let's let the market tell its own story in its own way. To be honest, readers of this service know that as far as I am concerned, the market gave its verdict last year in 1966. At that time, as I interpreted the Dow Theory, a long-term primary bear signal was given. The market was saying that the great bull market of 1949-1966 was over. The tide had turned. At 995.15 for Industrials and 271.72 for Rails the Averages had discounted and reflected the best that could be seen ahead for the great boom. When high tide is reached, the ocean begins its irresistable course towards ultimate low tide. I believe that we are on that course now.

When low tide is reached, then those of us who have had the patience to sit and wait in a generally liquid position should be able to reinvest our money and purchase fortune-making bargains in blue-chip and growth stocks. During the course of the bear market, readers who have taken my advice and invested 10% to 15% in gold shares might even receive a dividend in the form of vastly higher prices for gold shares.

I have written ad nauseum to the effect that I believed a 10 to 15% gold hedge was a good thing to have. I have never recommended selling or trading the golds. Lately, many of the golds have spurted in price, and a number of gold equities are now near their highs. For those who hold no gold shares I recommend equal part of American-South African and Dome Mines both on the N.Y.S.E. American Depository Receipts in the world's largest gold mine, Western Deep Levels, are also recommended.



WILD SPECULATION: Most people do not comprehend the basic change in attitude which must necessarily guide one during a rally and subsequent correction in a bull market— and a rally and decline during a bear market. The confusion is compounded because an extended rally within a primary bear market can look so convincing— often even more convincing than a rally in a primary bull market.

During an extended bull market long-term investors are entitled to "sit out" all declines in the knowledge that in time the primary bull tide will take hold again, thereby pushing the Averages and most stocks to new highs. But a rally (regardless of intensity) during a primary bear market is a "horse of an entirely different color." Forwhen the bear rally reaches its peak and tops out— that is the end. The highs have passed, and the market is headed down. In due time the Averages will break their preceding lows, and the bear market will be on in full force again.

For these reasons, most seasoned investors prefer to skip bear market rallies altogether. They know that very few bear market rallies are strong enough to produce real profits, and the risk of buying during an occasional profitable bear rally are generally offset by the risk of getting caught in one of the many deceptive run-ups and declines which punctuate every primary downtrend. In the final analysis, playing for profits in bear market advances is tantamount to trying for short-sale profits during bull market reactions. You can be lucky at times— but over any extended period of activity you are probably going to "lose your financial shirt."

The 1967 rally has provided a perfect laboratory in which to study the way in which psychology changes during bear market (upward) corrections. At the recent highs for the Dow, the majority of investors and traders had consciously or unconsciously slipped into the accepted bull market way of thinking. Most stockholders and analysts announced that they were perfectly willing to ride down any decline, firmly believing that "a minor correction of some sort" was in order. Following the correction ("hasn't it been that way for the past 17 years") the Averages were to rally to new recovery highs. This is the danger of a bull market stance during a primary bear market. For during a bear market when the rally is over, then one can "kiss the highs goodbye." When the rally has ended in a bear market it means that the primary downward force has taken hold again. It means that the peak of strength for the rally is over, that the market will head down again, and that in time the old lows will be penetrated as the bear forces come into full play again.

Therefore, it becomes of extreme importance to try to identify the area in which the "counter-primary" or rallying forces have spent themselves. Such areas are often characterized by extreme divergence in the Averages, intense speculation, a sudden flare-up in volume or a freakish relationship among some of the important indicators.

Referring to the last-named, I want now to direct subscribers' attention to the current schizophrenic action of the high-grade stocks in relation to the low-priced "cats-and-dogs." Older readers will remember that at the 1966 top I pointed to the freak spurt in Standard & Poor's Low-Priced Index to new all-time highs, even while the high-grade D-J Industrial Average was under distribution and sinking lower. I wrote that that was a highly dangerous situation, a situation in which informed investors were passing out stocks under the guise of a high-flying speculative market. As we all know, the informed investors won the battle, and between February and October almost all segments of the market caved in.

This type of action can be seen most dramatically on the long-term chart in this Letter. Here we see the S & P High-Grade Stock Index (HSI) and the S & P Low-Priced Stock Index (LPI). At the bottom of the chart I have drawn the ratio of the price of the HSI and the LPI. This is called the Speculation Index. When it rises, it means that the LPI is outperforming the HSI.

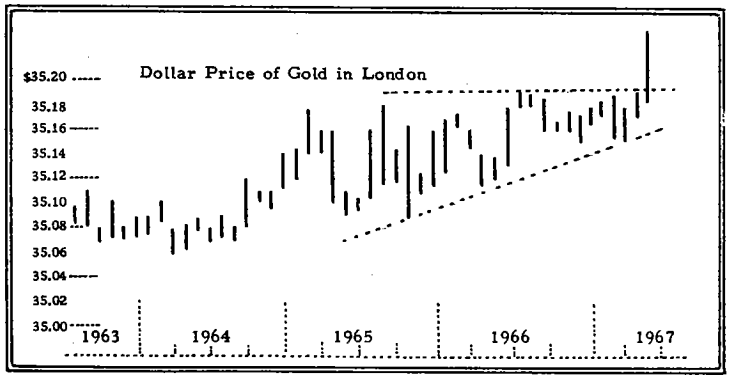
The 1966 situation is marked as number 3 on the chart, and at that time the Speculation Index rose to its highest level in 15 years. Note that although the actual HSI topped out in 1965, the LPI recorded new highs all through early 1966—until the collapse.

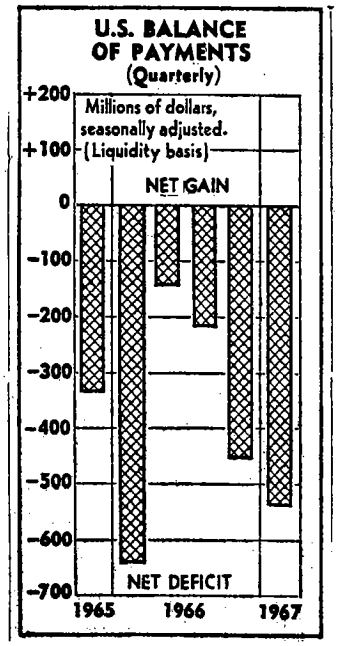
Now in 1967 this chart assumes new significance. For again during this bear market rally we see that LPI rising to fresh all-time highs, while the HSI struggles up on a half-hearted recovery from the 1966 lows (4 on chart). The implications are clear. Speculation in low-priced issues is again rampant, even while the high-grade issues are making little or no progress. I believe that as in 1966, we have again been seeing intense speculation while informed investors have been swapping blue-chip stock certificates for cash. It is a dangerous picture, and it is well to remember that the Speculation index has risen to a new high (above the 1966 high). At the same time average stock yields (see the last Letter) in relation to top-grade (AAA) bond yields are under the onus of the largest negative spread on record. All of this has occurred here in 1967 within the context of a confirmed primary bear market.

To recount a bit of history, the rise in the Speculation Index in 1951-52 (1 on chart) was brought on mainly by the first upward movement of low-grade stocks from their extremely depressed prices of 1949-50. This is a normal occurrence during the early stages of major bull markets; it occurred during the early 1920's and it occurred during 1933-34.

Note that the Speculation Index remained flat during 1961, at which time there was intense speculation (2 on chart). But the speculation in 1961 was largely in "new issues," and little attention was paid to the classical "cats-and-dogs" at that time. Thus, although the public displayed an insatiable appetite for speculative low-priced new issues, the Speculation Index in 1961 did not flare up into dangerous territory as it did in 1966 and as it has now.

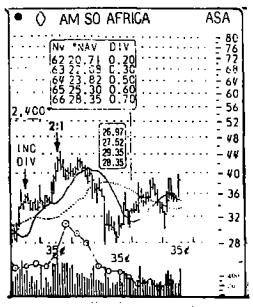
GOLD: I believe that the public has pretty much deserted the golds. Little interest was shown on the recent May run-up in gold shares. Most of the gold equities pushed to their highest prices in months, but hardly a murmur accompanied the move.



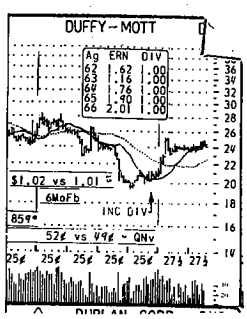


Nevertheless, the drama of gold is drawing closer and closer to the final act. The chart of the U.S. balance-of-payments is practically self-explanatory. The first quarter deficit was $539 million, the worst since the first quarter of 1966. The slow-down in Europe has hurt our exports, the war in Vietnam has run our expenses wild, and in general there is little hope of any improvement in our balance-of-payments over the foreseeable future. The picture is hardly one to bolster confidence in the dollar. On top of this, it is now clear that the U.S. is committed in the Mid-East, and any trouble there will bring in U.S. troops. But the mere fact of upheaval in the Mid-East heightens the world's desire for the safety of gold, rather than currencies. Finally, the cut-off policy on Treasury sales of silver points the way for the gold speculators. The greater the strain on the dollar, the nearer we get to that spark which will ignite a gold run. The position of the U.S. Treasury would then probably follow its position on silver. We would embargo gold, which would amount to devaluation.

I have included a chart of the dollar price of gold in London. This month, as silver was cut off, gold ran up to $35.24, then backed off to $35.19. Sales of gold in London were heavy. Sales of gold to feed speculators must be supplied in London by the Gold Pool, half owned by the U.S. Thus it is almost certain that the Pool lost gold during the May excitement. (Charts courtesy of Quote Digest, 110 Lorraine, Wichita, Kan.)



On the equity front I have shown charts of Dome Mines and American-South African. Both of these charts have now turned bullish, and the stocks are in position to reflect any pressure which may come into the gold market. I would like all subscribers to have at least a 10% hedge position in golds, and both of these issues constitute good participation in a gold play.



QUOTE OF THE WEEK (The Janeway Service, May 24): "No guessing game is involved here as to which horn of the dilemma the Administration is being driven to take. The deterioration of the long-term market tells the story, and the new sense of fear in the banking community confirms it. We are in for a wartime money squeeze. Because the war is so much bigger and more costly than it was at the time of the first Vietnam money squeeze, the second one is going to be worse—and it's going to be sharpened by the fact of its coinciding with a worldwide business recovery from an unnatural wartime slowdown which has been running counter to the activation of the war cycle."